Internal Revenue Service

memorandum

CC:TL-N-10096-87
Br1:CLRobertson,Jr.

date: SEP 30 1987

to: District Counsel, Atlanta CC:ATL

from: Director, Tax Litigation Division CC:TL

subject: Proper Years for Inclusion in Income of [redacted] Revenues

This is in response to your request for technical advice dated August 14, 1987, regarding the proper year for inclusion in income of certain revenue items received by [redacted], commonly known and hereinafter referred to as [redacted].

ISSUE

Whether amounts received by an organization from the "sale" of so called [redacted] which entitle the [redacted] to receive certain benefits are includible in income in the year received by [redacted]. 0451.13-00.

CONCLUSION

We agree with your analysis that the Service should take the position that [redacted] revenues should be included in income in year of receipt.

FACTS:

[redacted] was incorporated in [redacted] on [redacted], as a nonstock, nonprofit corporation to engage in all forms of [redacted] activity of a religious nature. On [redacted], its charter was amended to reflect the name change and to reflect its purposes: (1) to establish and maintain a church to provide a place of worship, and (2) to engage in all types of religious activity, including evangelism, religious instruction, publishing, and missionary work, both domestic and foreign, and establish and operate Bible schools and Bible training centers.

[redacted] was recognized as an exempt organization on May 17, 1973, under I.R.C. § 501(c)(3). It was classified as a religious organization described in section 170(b)(1)(A)(vi) and as an organization which is not a private foundation within the meaning of section 509(a)(1). It has been continuously classified as such by the Service since the initial ruling letter. Without notification or a request for church status, [redacted] has claimed status as a church which would be described in section 170(b)(1)(A)(i) since [redacted].

Pursuant to an examination of [redacted]'s records and activities for the above years, it was proposed that its exempt status under section 501(c)(3) be revoked effective June 1, 1980. The proposed revocation is based on the conclusion that part of [redacted]'s net earnings have inured to the benefit of private individuals and that it has not operated exclusively for exempt purposes described in section 501(c)(3). Further, it was determined that it did not qualify for classification as a church because its principal activity, the [redacted] activity, failed to satisfy many of the 14 criteria contained in the Service guidelines for classification as a church for Federal tax purposes. You note further that [redacted] does not have a body of believers or communicants that assembles regularly in order to worship.

The examination disclosed that [redacted]'s primary activity was its [redacted] production and [redacted] operation which included its principal [redacted], the [redacted], or as later known, the [redacted]. [redacted] were referred to as [redacted] and were the major source of support for [redacted].

In addition to the [redacted] operations and in conjunction with these operations, [redacted] conducted with its wholly owned, for-profit entity, [redacted]. Most of the revenues from these operations were reflected on the for-profit entity's books and records.

At some point after [redacted], and before [redacted], [redacted] began to solicit [redacted] for the [redacted] and the [redacted]. For a one time gift of $[redacted], the [redacted] ([redacted]) received [redacted] offered memberships in the [redacted]. For a one time gift of $[redacted], the [redacted] became a [redacted] which entitled him or her to the following benefits: [redacted]

[redacted]. The [redacted] offered under these programs was not transferable. [redacted] issued letters to the [redacted] stating that the payments were not deductible contributions.

Sales of [redacted] continued until [redacted], when they were stopped by [redacted]'s new president, [redacted]. Although you note that you do not have current figures, you estimate that [redacted] [redacted] were sold during the [redacted] [redacted] and [redacted]. [redacted], through its for profit subsidiary, also sold legitimate time-shares. The funds solicited from the [redacted] were originally intended to fund the construction of the [redacted] and the [redacted] [redacted]. The funds received, however, were commingled with other funds of the organization. Construction on [redacted] [redacted] commenced sometime during the last half of [redacted]. The [redacted] was partially completed and opened for business in [redacted]. Construction was completed on [redacted]. Construction commenced on the [redacted] in the spring of [redacted]. Construction ceased around [redacted] with the [redacted] remaining incomplete. It appears that the construction costs were substantially lower than the total amount of [redacted] revenues.

The [redacted] revenue is: for the year ending [redacted] [redacted], $[redacted]; [redacted], $[redacted]; [redacted]; $[redacted]. You estimate on the basis of partial year information that another $[redacted] would have been received by [redacted].

You state that you attempted to determine the value of the benefits provided to the [redacted] under these programs. You estimate on the basis of charges made to non-partners that a [redacted] [redacted] stay would cost a family of four approximately $[redacted] to $[redacted] for each year that such services were rendered.

One of the major problems faced in the examination of [redacted] is that it does not maintain records which would show the costs of providing the services to the [redacted] You do note that for the [redacted] month period that the [redacted] operated it had an operating loss of $[redacted] without benefit of any amortization of deferred income.

You further state that you attempted to determine how [redacted] treated the [redacted] revenues. The only information you have comes from financial statements and these are very confusing. It appears that [redacted] took the [redacted] revenue into income as expenses were incurred and, in addition, the balance of revenues over estimated future incremental costs was amortized into income using the sum-of-years-digits method over a [redacted] year period in general. No explanations were provided as to how the number of years was chosen, nor is it clear which costs were offset by the revenues.*/

ANALYSIS

Although it is not clear from the facts provided in your request for technical advice, we assume that the [redacted] revenues were received by [redacted], not its separately incorporated wholly owned, for-profit subsidiary, [redacted]. Receipt by the for-profit subsidiary would present the question of whether it should include these amounts in income, not its separately incorporated exempt parent. For purposes of answering the year of inclusion question, receipt by [redacted] is not necessarily receipt by [redacted]. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

For purposes of answering the question of when the revenues are includible in income, we are assuming that the [redacted] revenues are an includible item of income. Moreover, we believe the issue of year of inclusion of these revenues will be significant to the Service whether or not the exemption of [redacted] is revoked because the revenues appear to be generated from an unrelated trade or business activity.

You have stated that [redacted] has asserted these revenues were not generated from an unrelated trade or business although it has not specified the grounds for this assertion. If the Service takes the position that [redacted]'s exemption should not be revoked for the years in question and that these revenues were from an unrelated trade or business, it would be incumbent upon [redacted] as an exempt organization to demonstrate that the [redacted] revenues generated do not constitute unrelated trade or business income taxable under section 511 subject to the various modifications and exclusions applicable under sections 511 to 514. Thus, absent this showing, the year of inclusion question would still be significant under the unrelated trade or business provisions. These provisions generally parallel the taxation of for-profit corporate entities under section 11. See section 511.

*/ On the issue of which expenses were offset by revenues, we note that in the development of a proof of claim computation position, the Service should attempt to verify that no pre-opening expenses for the two recently constructed [redacted] ([redacted]) referred to above are deducted as business expenses under section 162(a) or the unrelated business income provisions. See generally, Aboussie v. United States, 779 F.2d 424 (8th Cir. 1985); Central Texas Savings & Loan v. United States, 731 F.2d 1181 (5th Cir. 1984); Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965), vacated on other grounds, 382 U.S. 68 (1965).

You conclude that the Service should argue that these "partnership" revenues should be taken by [redacted] into its income in the year of receipt. The trilogy of Supreme Court cases you cited, American Automobile Association v. United States, 367 U.S. 687 (1961); Schlude v. Commissioner, 372 U.S. 128 (1963); Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957), are on point. In essence these Supreme Court cases stand for the proposition that deferred reporting of advance payments for future services beyond the year of receipt will not clearly reflect the taxpayer's income for that year within the meaning of section 446(b). Based on the facts provided, the "partnership" amounts were advance payments for future services.

Section 451(a) states the general rule:

> The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 446(b), in referring to an accounting method used by the taxpayer, provides in pertinent part:

> [I]f the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

Treas. Reg. § 1.451-1 provides in pertinent part:

> Under an accrual method of accounting, income is includible in gross income when all of the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amouunt thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made.

Under Rev. Proc. 71-21, 1971-2 C.B. 549, the Service provides certain exceptions to its rule that advance payments for services are includible in an accrual basis taxpayer's income in the year of receipt. In general, the accrual basis taxpayer who receives a payment for services to be performed in the present or future years may include the payment in income as it is earned through the performance of the services as long as the income is not deferred later than the end of the year immediately following the year in which the agreement for the services was made.

Since the services contemplated by the [redacted] revenues are for life time periods, the revenue procedure's exception from the year of receipt inclusion rule is not applicable to [redacted]. Further, under the facts in the instant case there was no expectation of a refund in the event that the services were not used. In addition, there were no restrictions on the future use of the [redacted] revenues. Indeed, [redacted] commingled the partnership revenues with other revenues. Under Treas. Reg. § 1.451-1, the [redacted] revenues are includible in the year received by [redacted] because all events have occurred which fix the right to receive the income and the amount thereof can be determined with reasonable accuracy. The right to receive the income was fixed and the amount of the income was determined by the amounts actually received.

The settlement agreement made between [redacted] and the [redacted] Tax Commission pursuant to their conference on [redacted], cannot control the result in this case. The legal basis for that settlement is not shown. Further, it is of interest to note that the [redacted] Tax Commission's legal position was that the [redacted] revenues were immediately includible in [redacted]'s income in the year of receipt as advance payments for rentals or charges for use of rooms under the state accommodations tax. Actual use of the rooms was not necessary for the income to be included in income.

Finally, we agree with your analysis that Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968), or Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl. 1976), cert. denied, 429 U.S. 86 (1977), are not applicable. The Service will not follow Artnell insofar as it goes beyond the deferral rules set forth in Rev. Proc. 71-21, 1971-2 C.B. 549. Artnell Co. v. Commissioner, A.O.D. (July 27, 1971). Further, the Service disagrees with Boise. Boise Cascade Corp. v. United States, A.O.D. 13775 (Feb. 19, 1986). In these cases the court permitted deferral of income where the time and extent of future services were fixed. As you noted the dates, nature, extent and cost of the future services in this case were not known.

Further, the [redacted] revenues do not fit within the concept of a nontaxable deposit because [redacted] had unrestricted control over the revenues, commingling them with other revenues; the partners had no expectation of nor was there a provision for a refund; [redacted] had no control over the disposition of the revenues; and [redacted] did not pay interest on these amounts. See Astor Holding Co. v. Commissioner, 135 F.2d 47 (5th Cir. 1943); Hirsch Improvement Co. v. Commissioner, 143 F.2d 912 (2d Cir. 1944); Illinois Power Co. v. Commissioner, 792 F.2d 683 (7th Cir. 1986); City Gas. Co. of Florida v. Commissioner, 689 F.2d 943 (11th Cir. 1982), on remand, T.C.M. 1984-44.

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